RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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May 20, 1981 **LETTER 809**

May 8, DJIA 976.40; PTI 1448; A-D Ratio –17.73
May 15, DJIA 985.95; PTI 1466; A-D Ratio –17.46

THE PICTURE: According to Dow's Theory, the prevailing trend is taken to remain in force until PROVED otherwise. The trend of the market was last confirmed as bullish – therefore the trend is taken to be bullish now. True, we have non-confirmations, we have divergences, we have lags, we have a battered and bruised money market and we have record high interest rates. But the fact is that we have no authoritative evidence to indicate that the primary trend is anything but bullish.

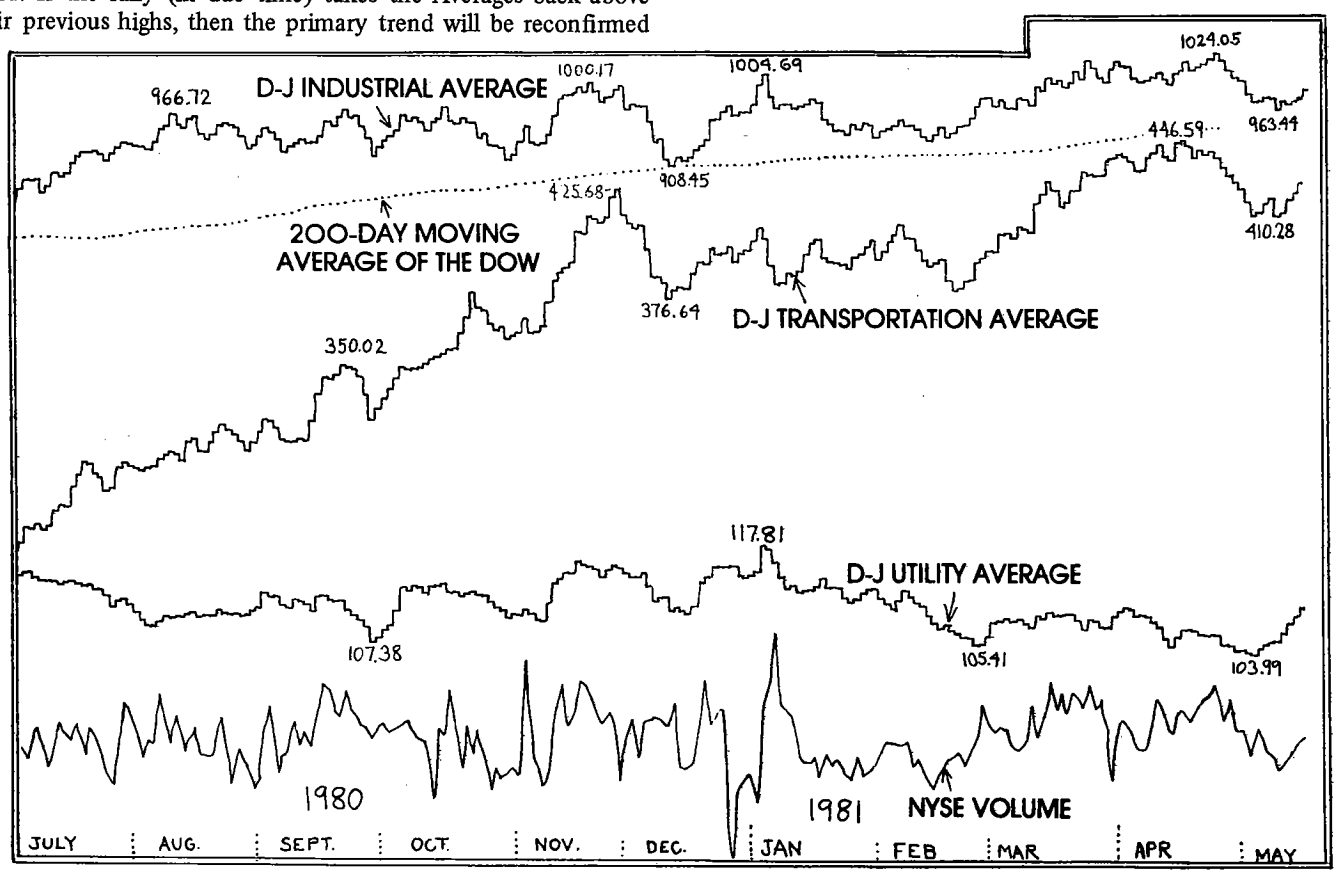
"What's the importance of the primary trend?" you ask. Here's the answer: If the April–May decline was simply a reaction in a bull market, then the Averages will work up and in due time push to new highs. By the same token, the business and economic problems of the nation will straighten out and within a matter of months we will be on our merry way again. But if the primary trend has turned bearish, then we can be sure that this nation and its markets are heading into an area of increasing problems and crises. Worse, if a primary bear market is in force – all the Fed's efforts, all the President's hopes, all Congress's laws, are not going to help or halt the situation (in fact, manipulating or attempting to reverse the primary trend will simply intensify the bear forces during an ongoing bear market).

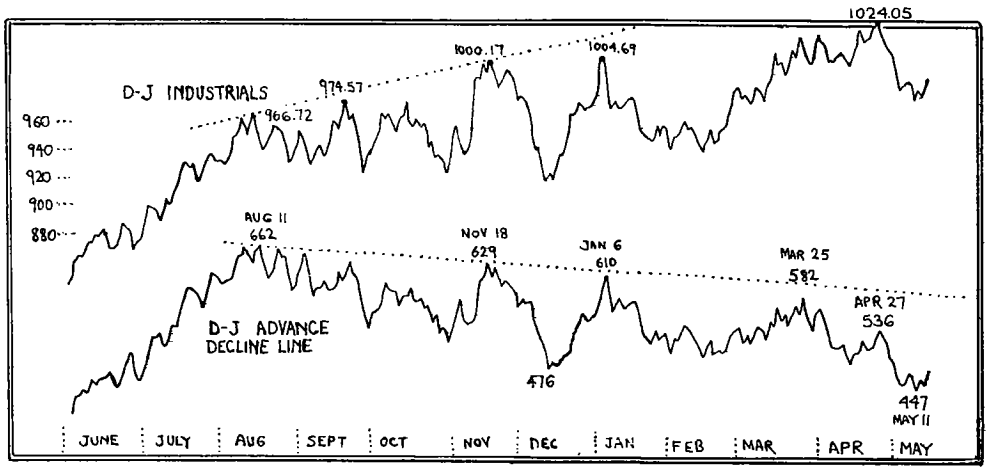
Next question: "How will we actually know when the primary trend has turned bearish?" The answer stems from what the market does AFTER a secondary reaction. Following secondary lows in the D-J Industrials and Transports, there will be a new rally. It is this new rally which contains the secret of the primary trend. If the rally (in due time) takes the Averages back above their previous highs, then the primary trend will be reconfirmed as bullish. But if the Averages advance but fail to better their old highs (BOTH Averages must better the old highs), and they turn

FRONT PAGE COMMENT: What's "the shock of the year" as far as Wall Street is concerned? It's hardly a surprise to my subscribers, but the shock of the year is the new rise in interest rates (a rise that is continuing even as this Letter is written).

What's the "biggest game in town" as far as Wall Street is concerned? It's guessing what day or week the top for the interest rate spike will arrive. Frankly, guessing at the top doesn't intrigue me. And the reason that it doesn't is that the game is far too costly. Already it has cost bond and mortgage holders $10's of billions of dollars in losses this year. In fact, the whole ongoing crash in money instruments is what I term "the money market's counter-part to the 1929 crash in the stock market."

Just as 1929's meaning was not perceived until much later, so, I think, the money market's crash is not going to be understood until much later. One meaning of the money market crash is clear, however, and it is this: the prognosis for the debt-ridden US consumer is for a lowered standard of living in the future. We've "spent it" over the past 25 years, and pay-off time is here. You can see it in lowered expectations for housing, smaller cars, trimmed Social Security benefits, less beef consumption, and on and on. And still the debts continue to rise!(see money market comments in this Letter).





Meanwhile, an equally extraordinary performance is being exhibited by the Primary Trend Index (PTI). The PTI is my own proprietary index, and this Index is now being followed (on a trading basis) by thousands of my subscribers. The PTI measures (on an on-going, daily basis) the build-up or deterioration in technical strength on the NYSE. Study the chart on page 3. Note that since June, 1980, the PTI has been walking up (above) an extended rising trendline. That trendline has been approached or tested on five separate occasions since mid-1980. On each test the trendline has held, following which the market has rallied strongly.

down – at the point where the two Averages break their secondary lows a bear market will be signaled.

It's a bit early to tell, but it appears that the secondary lows for the April–May reaction were the May 11 lows of 963.44 (Industrials) and 410.28 (Transports). The big question – will the Averages now move through the highs, or will the May lows be penetrated?

According to my cycle studies (see cycle chart, last Letter), the market is now in the downward segment of the latest 233-day cycle. The bull segment of this cycle began last December (908.45 on the Dow) and ended on April 27 (Dow 1024.05). From that recovery high, the bearish segment of the cycle took hold, and the downward cyclical bias should remain in force for approximately 89 days to a low which I estimate will occur around the end of July. How the market fares between now and late-July will tell us a lot about the underlying strength or weakness of this market.

One technical study has me rubbing my eyes in disbelief. I've written a good deal lately about the price/breadth divergences in this market. In Letter 807 I included a special study of the Dow and its own A-D line. The Dow A-D line is a running daily count (pluralities) of the advances and declines in the 30 Industrial issues.

I have been following the Dow and its A-D line for many years, and divergences here are unusual. If there is a divergence, it is usually corrected within a few weeks or so. But as you can see on this chart, the Dow and its A-D line have parted company for the past 9 months (ever since August 11), a price/breadth divergence unmatched in modern history!

Note on the chart that since mid-August the Dow has recorded five distinct and separate higher peaks, the last being the 1024.05 high of April 27. During that same period the Dow A-D line has recorded five successively lower peaks, the latest being the April 27 peak of 536. Following this last peak, the Dow A-D plunged to a 10 month low of 447 (May 11). Thus, between August, 1980 and May of this year the Dow advanced 58 points (from 966 to 1024) on a peak to peak basis. During that same time the Dow A-D line dropped a total of 126 on a peak to peak basis.

Frankly, I've never seen anything like this abnormal technical performance. How long this can go on prior to a major swoon in the Dow, I don't know. But what it does show is that even within the Dow Industrial Average itself, the strength has been viciously selective. And selective markets are not safe markets.

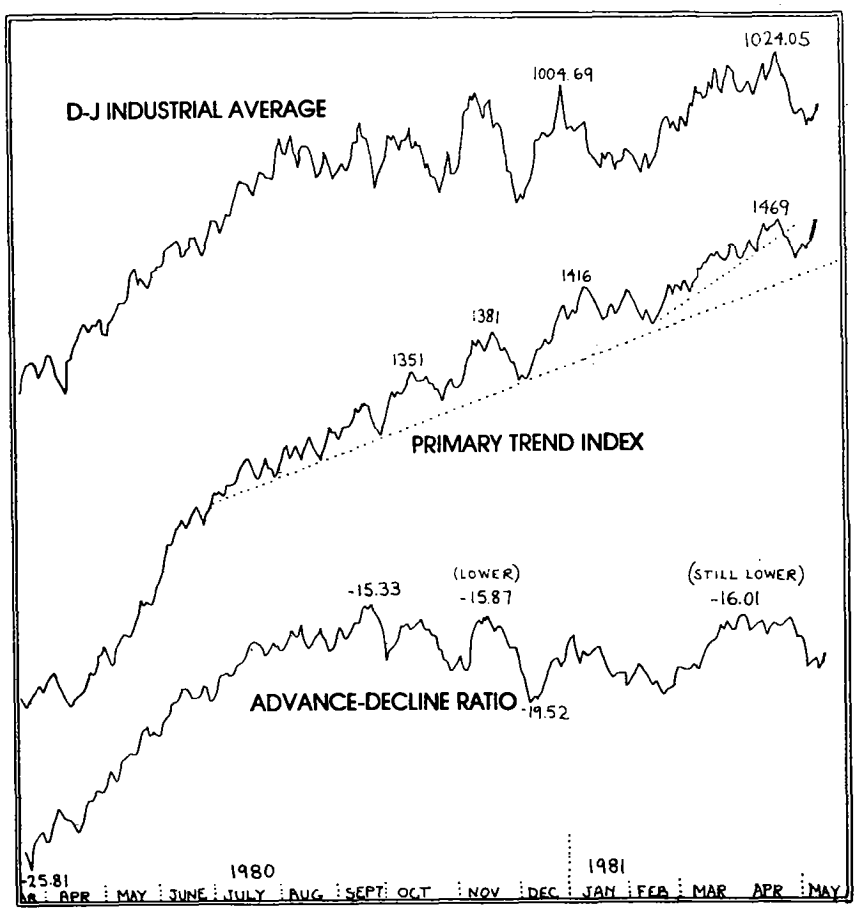
A few weeks ago we saw another near-test of the trendline, but on May 6 the PTI turned up, and as this is written the PTI is within a few points of another new high (see Late Notes at the end of this Letter for more on the PTI). I've said it dozens of times in dozens of Letters, but I might as well say it again – this market is not going to unravel, fall apart or crash while the PTI holds above its trendline, and I don't care what divergences appear or what some other analyst predicts or what dire threats hang over Wall Street. While the PTI is in a rising trend, the back of this market will remain unbroken!

At the bottom of the chart we see the advance-decline ratio for the NYSE. This is a proxy for the action of all the stocks listed on the Big Board. The ratio has been moving sideways with a downward bias ever since September of last year. As this is written, the A-D is in the mid-range between the high of last September 19 and the low of last December 11. Thus, the A-D has held within a 4 point range for 12 months. Sooner or later, it's got to break out of that range – and make its move.

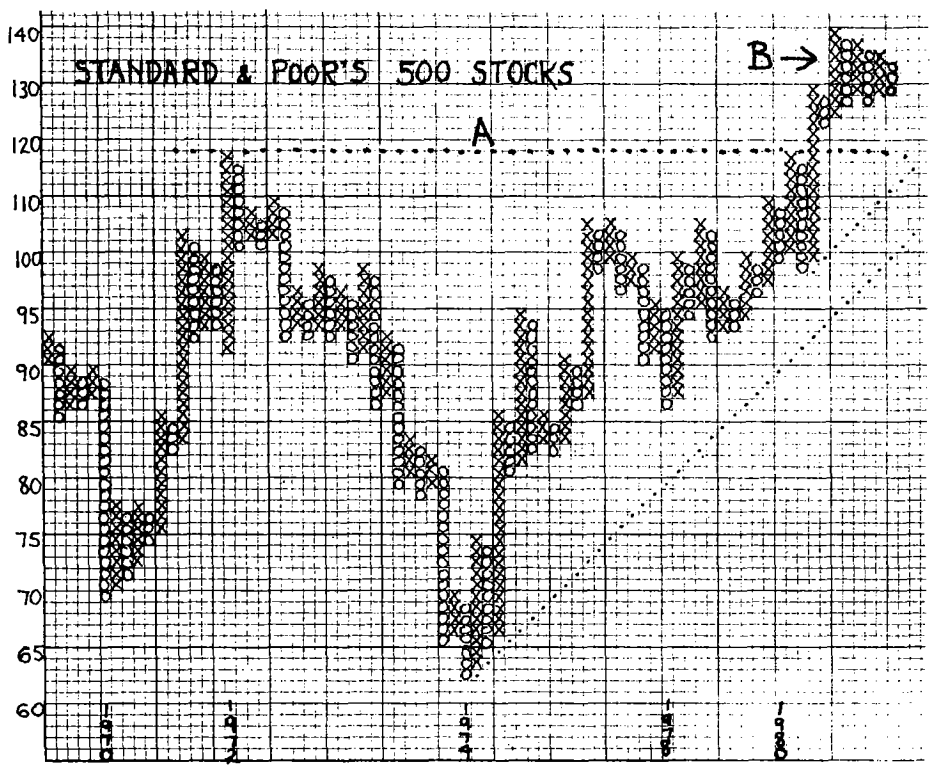
INVESTMENT POLICY: You can make a case for calling this market a picture of revolving strength or a picture of revolving weakness. Holders of the suggested no-load mutual funds are warranted in retaining those positions as long as the PTI is bullish. I've suggested that the bulk of funds be placed in 91-day Treasury bills, and I still like this position. In terms of risk-to-reward, the T-bills are a fine place to be (particularly since the real return is now about 7%, after factoring out inflation). Gold positions of up to 5% to 10% of assets are warranted. Unlike IBM or GM (or even Toyota), gold is "forever."

PERSPECTIVE: At the bottom of page 3 we see a point & figure chart of the Standard & Poor's 500 Stock Average going back to 1969. This is a 2x6 point & figure chart, and this means that each box equals 2 points on the Average, and only rallies and declines of 6 points or more are depicted. Thus, the chart condenses a great deal of price action into a limited space. And from this kind of charting, we can often see phenomena which would be totally obscured if every day's (or even every week's) action were shown. A point & figure chart is not concerned with time, it is concerned ONLY with price action. Thus a 10 point rally in the S&P 500 could occur in a few days or six months. It would appear exactly the same on this chart.

The action of the 500 since the 1971 high takes on the appearance of a gigantic base with the low point obviously being set in 1974. The rise from the 1974 low of 63 to the 1978 high of 119 appears to have completed the base. The breakout came in 1979



when the 500 Average pushed above the resistance at 119 (shown on the chart as horizontal line "A"). From this breakout move, the 500 pushed up to the November 28 peak of 140.52 (shown as 140 on the chart). And since then, the 500 Average has lapsed into what is known as a "congestion pattern," and I have labeled this "B" on the chart.



As far as P&F analysis is concerned, the next move of importance will be either (1) a rise by the 500 above 140 to the 142, thus inaugurating a new advancing leg, or (2) a decline to 126, thereby setting off a bear signal and implying a test of the 119 original breakout area.

As I see it, the congestion area at B is the first important formation following the breakout above 119. To my mind, it would be quite bearish if, following B, the 500 Average broke down and sank below the 119 level again. Conversely, if the S&P can rally to 142 it will place an unbearable pressure on today's 75 million shorts. A breakout above 142 could set this market heading substantially higher as million of shorts run to cover and cut their losses.

Conclusion: 142 and 126 are critical levels for the widely-watched S&P 500. Whichever level it touched first will have major implications for Wall Street and the economy.

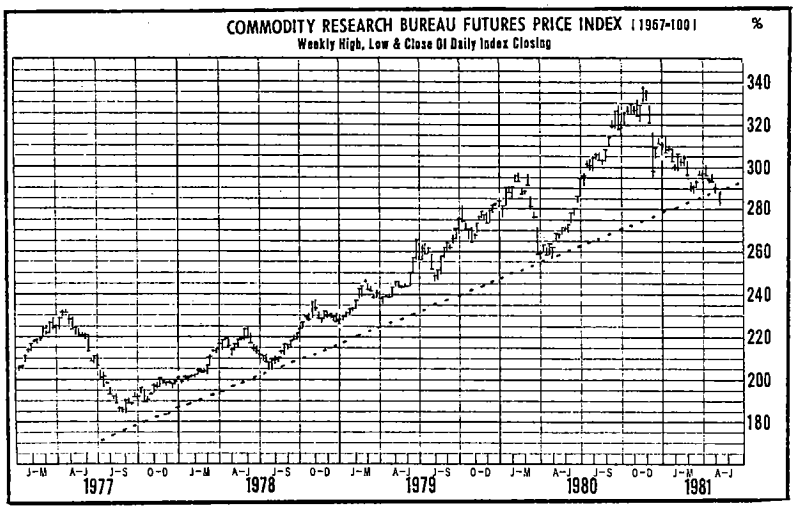
MONEY MARKETS: America has a total of $5 trillion in debts of all kinds. What's happening to this ocean of debt? At accelerating rates, this entire $5 trillion is being "rolled over" (i.e., refinanced) at today's record interest rates. Yet not one in a thousand people understands what this means. Example: the average yield on the Federal debt (the Federal debt is now near $1 trillion) is 3.9 years. The average yield on the Federal debt is about 11.5%. As the older bonds and notes mature, they will be refinanced at today's new near-record rates (around 14% for bonds vs. lows of around 3% to 4% in the 1940's).

By the same token, S&L's and banks have about $400 billion sitting around in their pass-book accounts, and all paying at the old rate of 5½%. Recently the S&L's have received permission to start what is literally their own money market funds. The result will be a mass movement of "cheap" pass-book money into the 15-18% interest rate range. Conclusion: new highs in costs of money for the savings institutions.

Last week the CRB Commodity Index (see page 4 chart) broke a five-year rising trend. That reversal represents a *major crack in the inflation structure.* During the same week the price of oil was lowered, another sign of ebbing inflation. But all along the "experts" have been promising us that "interest rates will come down when inflation recedes." Now these same experts are flabbergasted to see the inflation rate declining, commodities skidding – and interest rates near record highs!

How can this be? What's happening? What's happening is a severe cash shortage, illiquidity, a giant squeeze as America's debt-to-assests ratio put the pressure on government, corporations and individuals.

Weiss Research (Box 2923 W. Palm Beach, FL 33402) estimates that there is now $1.2 trillion in *short term debt,* and that debt requires refinancing at the rate of $100 billion a month!



In the face of that kind of cash need, something akin to panic is hitting the money markets. Bond isssues are being shelved, those bonds that do hit the market are selling slowly (even with fat yields and in many cases record yields), and confusion has overtaken the bond dealers.

Meanwhile, a two-pronged problem hits the money market. Corporate and government demand for new capital is rising, even in the face of lower profits. But new capital generated from personal saving is dropping. In first quarter 1981 personal savings dropped to $91 billion, down from $98 billion in fourth quarter 1980 and $111 billion from 1980's third quarter.

Where does it all end? It will end with an interest rate spike, a spike that is probably in the formative stages now. Prognosis for readers of Dow Theory Letters: stay in 91-day T-bills. Never have money-minded investors enjoyed such a fat return with so little risk (almost 17% return at the time of this writing).

MARKET MUSINGS: One of the things that bothers me about this market is the extreme (actually historic) TIME SPAN between the last high in the A-D ratio and the recent highs in the Dow. The A-D ratio (a proxy for ALL NYSE stocks) topped out on September 21, 1978, fully 2½ years ago. A lower peak was recorded last September (see page 2 chart), and all the while the Dow was pushing to new recovery highs.

Thus, we have witnessed the longest price/breadth divergence in stock market history. Such divergences have, in the past, preceded major trouble in the stock market, and I frankly wonder what a 2½ year divergence is going to mean.

* *

Another worrisome consideration (see last Letter) is the divergence between the broad Averages such as the S&P 500 and the NYSE Index – and the Dow. The broad Averages topped out last November 28, five months before the recent April 27 (1024.05) top in the Dow. What all this means to me is that the general market has been subject to bearish forces for five months (2½ years if we consider the A-D ratio) even while the Dow Industrials and Transports were recording new highs – right up to April 27.

* *

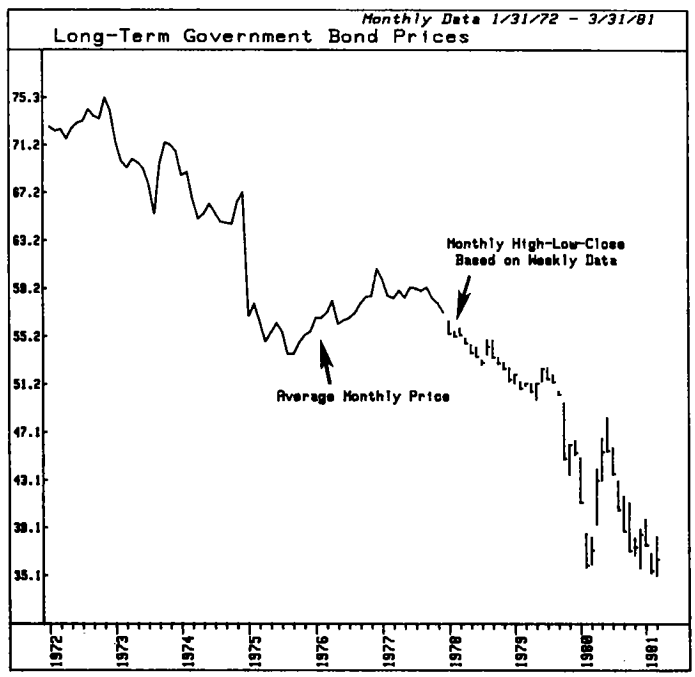
It bothers me that there's so much money in the money market funds (these funds are really a proxy for commercial paper and bank certificates of deposit). I continue to advise that the great bulk of your money be in T-bills – with only small amounts in money market funds (hold cash in the funds for convenience only).

* *

I hope this isn't a sign of the times – but obviously it is. Mighty GM, once considered one of the best-run corporations in the world, is now in a cash bind. GM is considering selling its main property in NYC (for a reputed half billion), and as of May 5 GM is delaying parts of its five-year capital spending program. If it's happening to GM, you know its happening to many other big corporations (and many more small ones).

* *

It is estimated that the bond markets are eight times as large (in value) as the stock markets. One nightmare thought I have is this: we have, since 1978, been seeing the counterpart of 1929-32 – but we've been seeing it in the bond market. This chart of long-term Government bonds (courtesy of New Davis Research, Venice, FL) shows the utter collapse that has occurred in bonds. "What does this augur for the economy?" I ask myself. If the debt of the US and its corporations and its citizens (the latter



through a collapse in mortgage values) has caved in, then what are the markets trying to tell us? My own feeling is that the hundreds of billions of dollars that have been lost in the bond and mortgage markets WILL have their effect on the economy – and soon. Remember, America was built on cheap, long-term money. The instruments of this cheap, long-term money – bonds, have been pulverized.

* *

This is the first time the Federal Reserve has allowed a squeeze in the money markets – with actual encouragement from the incumbent Administration. Previously, the Fed has always flooded

the market with credit once a squeeze has begun to hurt. Doubtless, many skeptics expect the same thing to happen this time. But Fed credibility has been battered too many times. I think the Fed means to squeeze and to HOLD that squeeze this time!

With corporate and government requirements for money rising, and with a squeeze in the money markets, the final product should be unprecedented new highs in interest rates, and a potential panic for cash. When a panic is on, people pay outlandish prices for the wanted item, whether that item be gold, water, oil, stocks or tulip bulbs. This time it's going to be MONEY. And that's why I have insisted that my subscribers build up and retain LIQUIDITY, preferably in T-bills.

NOTES & QUOTES: I have to smile when I read some of the services as they try to back up their own positions. For instance, on May 8 a bearish service(well known and very respectable) sent out this description: "Since our issue of April 24, the Dow Jones has performed exactly as we predicted. Although the Dow is down almost 50 points, the carnage among the high multiple stocks is even more severe. Many issues are off 30% and some low priced speculative stocks have dropped in half."

About the same time, a (very intelligent) bullish service sent out this description: "For a great many stocks the enjoyable rally from the February lows has given way to some retracement of recent gains. It is interesting to compare some key averages: the capitalizations weighted S&P Composite has lost only about two-thirds of its gain since the last rally. The unweighted Value Line Composite has lost only about one-third of its gain...."

When divergences abound (as they now are) and when the bond market is sliding (and it has been) and when the 233-day cycle is bearish (it is now), the risk is high and probabilities say that it's very difficult to make any real money in the market. The still-bullish PTI says that you won't lose your shirt yet, but that's not enough for me at this juncture.

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From our "Coming Trends" Dept...

> **FORT LAUDERDALE, Fla.—City officials here have approved a plan to teach city residents how to use handguns.**
>
> **For a $25 fee, any resident owning a gun can register for a program that provides two hours of classroom instruction and two hours of pistol range practice and instruction. Police officials said within the first 24 hours they have been "inundated" with requests for registration, which begins May 16. They said the requests are coming from neighboring cities, too, although the program is designed only for Fort Lauderdale residents.**

A workshop, "Self-Defense with Mace," will be held at the University of San Diego on May 16, from 9 a.m. until noon in Salomon Lecture Hall.

Advance registration is required and tuition for the workshop is $35. Participants will learn safety and protection

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Fortune magazine (May 18) contains an excellent article on Salomon Brothers' bond and money expert, Dr. Henry Kaufman. Kaufman is one of the three or four most important opinion-shapers in the nation (in the money field), and I thought a few excerpts from the *Fortune* article would serve my subscribers well. Here they are....

Kaufman's doomsday pitch, insistently repeated over the past three years, has made him famous. His disdain for the "excesses" of the credit market reflects more than dismay that the financial system accommodates rather than combats inflation. It reflects as well a personal disdain for what he regards as "a lack of discipline" and a failing in fiduciary responsibility. He deplores the "entrepreneurial spirit" in banking, regarding it as inappropriate with other people's money, and is affronted at the suggestion that the financial markets are a *game*. "We are not a casino," says Kaufman.

He remains bearish. He thinks the Administration's economic program is inflationary, and while he personally believes that the Fed will stick to its resolve to hold the money supply to the announced growth targets, he doesn't think the market believes it. As he sees it, the Fed's effort will exert upward pressure on interest rates during the year as loan demand increases, but the policy won't moderate inflationary expectations because "no one will accept a promise of the Fed that it will adopt a disciplined approach." The Fed has promised too much before.

In his sharpest departure from the economic consensus, Kaufman believes that an explosion of credit is likely even if the Fed hits its targets. "The financial markets are very innovative, and we're going to find some more substitutes for money," says Kaufman. "We can drive that credit mechanism very hard." Thus he foresees an increase in the velocity of money far beyond past experience. At some point, Kaufman believes, the dizzying upsurge will end. "But we don't know how high the Fed has to raise interest rates under this monetarist approach to turn borrowers off."

He forecasts a prime rate reaching and perhaps topping last year's high before 1981 ends, by which time triple-A utility bonds will be in the 15% to 16%-plus range. He expects more real economic growth than most forecasters: an average of 2.2% for the year, including a 3% to 4% rate in the second half. Inflation will stay in its current range, with the GNP deflator rising 10% or 10.5% during the year.

A stern prescription

To achieve a happier scenario, at least in terms of inflation and interest rates, Kaufman offers a stern, disciplined approach of his own. He would have the Fed control credit through the use of capital ratios. The banks, of course, are currently forced to maintain ratios of capital to assets, but only to make sure that they have enough money to cover loan losses. Kaufman would impose large capital ratios on banks, thrifts, and insurance companies to limit the availability of credit. But that is in the area he calls "what should be, not what will be." He does not see it happening. So he continues to be bearish, for the country as for the bond market.

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I've been asked what I read. I'll admit it; I'm a reading-freak and particularly a newspaper and magazine freak. Here a glimpse into my madness:

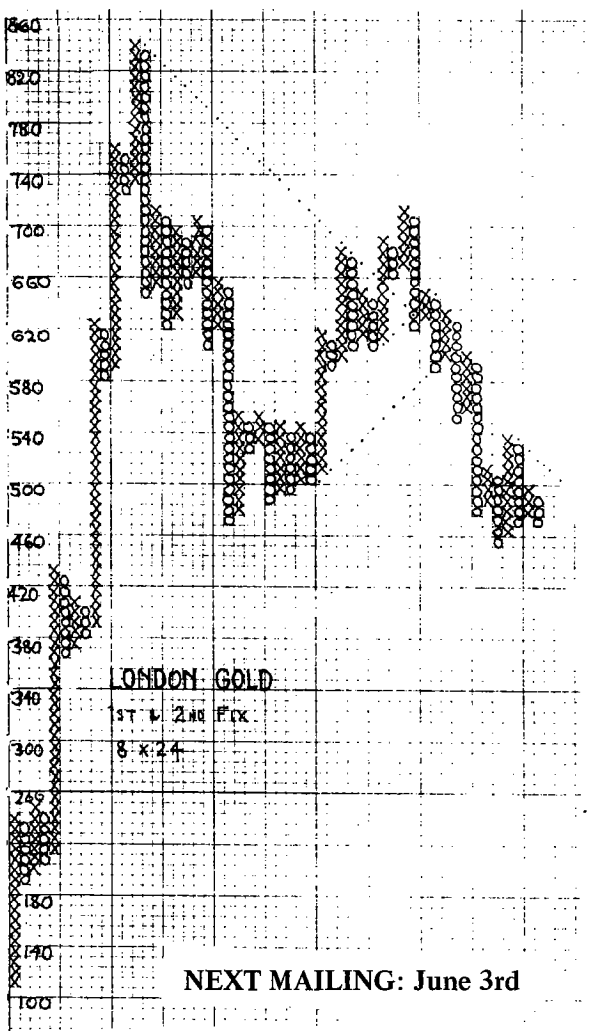
Each day I read the *San Diego Union* (local and a fair paper), the *Christian Science Monitor* (an excellent paper with many original, concise informative articles). Besides the *Monitor*, the only other national paper is the *Wall Street Journal*, now (incredibly) the largest-circulation daily in the nation. The *WSJ* is a great paper, absolutely tops for financial news. Then I read the *New York Times*, the finest all around newspaper in the nation. The *Times* is the paper of record and now it's far more interesting (dare I say racy) than it was ten or even five years ago. I also read the *Los Angeles Times*, and although there is room for improvement here, this is a good regional paper with outstanding special stories on the front page (left column) every day. Artistically the *LA Times* is the ugliest paper in the country.

I'm always reading two to four books at a time. Right now I'm reading the new (excellent) biography of John O'Hara. I just finished the Walter Lippmann biog. I love biographies, because I find what other men did, what they thought, how they live their lives, to be far more interesting than fiction (I don't read much fiction now, although I used to).

Magazines: Here we have *Barron's*, the nation's outstanding financial magazine. Then I read *Forbes*, which is now a very good magazine (I never liked it until about three years ago, when evidently Malcolm decided it was time to improve). *Dunn's Review* contains many interesting financial articles, and I like the new bi-monthly *Fortune*, which is in severe competition with *Business Week*, which I also read (*BW* has finally dropped its mindless bullishness, and it has finally decided to deal with many major US problems.

The rest of the list of magazines that I read goes on and on: *Town and Country, Life, Time, Newsweek, Science Digest* (newly done over and great), *Reader's Digest, Black Belt, Guns & Ammo* (the last two are no mistake, and I like them), *Architectural Digest, Smithsonian* (wonderful mag), *National Geographic, Art in America* (I'm an art nut), *Harpers* (at least one outstanding article an issue), *Consumer Reports* (I don't know why I get this because I never really believe their reports), *Vogue, Bazaar, "W", Penthouse* and *Playboy* (often good articles in these last two, and I'll admit it, the girls don't bother me), *Soldier of Fortune* (a wild mag for gun-nuts and mercenaries), *People* and *US* (I like these two, blushingly), *National Enquirer* (I like junk too). I guess I should also mention one of my favorites, the *Cactus and Succulent Journal* (Cactus collecting is my hobby, and this remarkable magazine has been published without ever missing an issue since 1929). Oh yes, there's *New York* and *New West*, both sort of disappointing, but I keep hoping. Well, that's most of what I remember now, and I think it will give you an idea of what magazine madness is all about.

GOLD: There are a lot of bears on gold, and lately many of them have switched their allegiance to the so-called "strategic metals." I've been asked what I think of investments in these metals, and my answer is, "Not much." There's very little liquidity in the rare metals, they're tricky to buy and even trickier to sell. Furthermore, it's my opinion that if the US Government finds itself short of any of these metals, they're going to confiscate them. So my advice is stick to stuff you can buy and sell in a flash, like gold, silver, copper and zinc.



NEXT MAILING: June 3rd

I guess the whole gold story is here on this point & figure chart. Each box on the chart equals 8 points, and only rallies or declines of 24 points or more are depicted. That gives us a lot of concentration, but often a simple, concentrated story is better than a long, meandering one.

The chart shows a recent decline from 720 to 460 (the actual low fix was 457). After that gold went into a area of indecision bordered by 540 on the upside and 450 on the downside. Within this "puzzle area" I think I've heard every opinion under the sun. But to my mind, it's impressive that gold has HELD even while interest rates were roaring to new highs, even while almost all commodities were doing swan dives, even while platinum and palladium and silver were weak, even while many former gold bulls talk about "350 to under 400" for gold.

Now the rate of inflation is coming down, the rate-of-change on the CPI is sinking, and anyone who isn't a bulldog can see that there's some dis-inflation in the air. Still gold refuses to break down. Therefore, I feel time is on gold's side. The longer the time elapsed with gold still holding above 457, the better the picture for the metal.

Of course, from a risk/reward basis, there's a problem in holding gold. That problem is that in two years you can get 33% on your money via T-bills or a money market fund. That isn't glamorous, but it's as safe and as fat a guaranteed return as this generation has ever seen. Now gold has to rise to about 640 to give you the same return over the next two years – and nobody is going to guarantee that kind of performance. Of course, gold could go to 800 or 1000 by 1983 – but blast it, nobody can guarantee it.

Therefore, we've either got to limit the amount of insurance gold we hold, or buy it when it's moving out, and by moving out I'd say moving first above 520 and then above 540. In the meantime, sit tight, don't get overly eager, don't develop that Vegas urge, and collect your interest on those boring T-bills. Don't worry, the money you get on the T-bills is just as spendable as the greenbacks you'd make if you bought GM at 54 and could sell it at 60.

Gold momentum (13 week rate of change) was 96 last week, still improving but not above the critical 100 level. The 5-week moving average for gold is now 485, well below the 13-week MA–now 499. The long-term or 50-week MA for gold is declining at the rate of 2 to 3 points a week and now stands at 543. Thus there is no buy signal yet for gold on the moving average studies (the first hint would be spot gold holding above 500 on a consistent basis.

LATE NOTES: The PTI closed the week ending May 15 at 1466, just 3 points from its 1469 high recorded on April 27. Any real strength this week will almost surely put the PTI at a new high! One thing is clear, very clear, and that is that the "backbone" of this bull market has not yet been broken. From the standpoint of the Averages, the critical levels are there for us to monitor–they are 1024.05 (Industrials) and 446.59 (Transports) on the upside. On the downside we have 963.44 and 410.28. Meanwhile, the PTI is telling us that the pressure is on the short sellers–it's as simple as that.

The current (May 25) issue of Forbes has not one but two articles both suggesting that bonds have hit an historic bottom. The lead-off article in the magazine notes that the "real return" on bonds is now at an all-time high. But what they don't understand is that it's not inflation that is driving down bond prices now, it's illiquidity and debt.